U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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OPENING STATEMENT BY SECRETARY HENRY M. PAULSON, JR.
ON REGULATORY REFORM
BEFORE HOUSE COMMITTEE ON FINANCIAL SERVICES

Washington, DC— Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. Thank you for the opportunity to talk with you this morning and for your continuing leadership on the many issues facing our financial markets.

Shortly after I came to Washington, I pointed out that our financial regulatory structure has not kept pace with financial services market evolution over the past decades. And so in 2006, Treasury began work to outline a new financial regulatory structure that is better suited to protect investors and the stability of the financial system, and support the innovation and risk-taking that fuel our economy. We released our Blueprint for a Modernized Financial Regulatory Structure, in March of this year.

In the Blueprint, we recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators: one focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility and that, because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. If implemented, these recommendations eliminate regulatory competition that creates inefficiencies and can engender a race to the bottom.

The Blueprint also recommends a number of near-term steps. These include formalizing the current informal coordination among U.S. financial regulators by amending and enhancing the Executive Order which created the President's Working Group on Financial Markets and, while retaining state-level regulation of mortgage origination practices, creating a new federal-level commission, the Mortgage Origination Commission to establish minimum standards for, among other things, personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and appropriate licensing revocation standards.

The Blueprint includes recommendations on a number of intermediate steps as well – focusing on payment and settlement systems and on areas, such as futures and securities, where our regulatory structure severely inhibits our competitiveness. We recommend the creation of an Optional Federal Charter for insurance companies, similar to the current dual-chartering system for banking, and that the thrift charter has run its course and should be phased out. We also recommend the creation of a federal charter for systemically important payment and settlement systems and that these systems should be overseen by the Federal Reserve, in order to guard the integrity of this vital part of our nation's economy.

When we released the Blueprint, I said that we were laying out a long-term vision that would not be implemented soon. Since then, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system, and has convinced me that we must move much more quickly to update our regulatory structure and improve both market oversight and market discipline. Over the last several weeks, I have recommended important steps that the United States should take in the near term, all of which move us toward the optimal regulatory structure outlined in the Blueprint. I will briefly summarize these.

First, Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But the Fed does not have the clear statutory authority nor the mandate to do this; therefore we should consider how to most appropriately give the Federal Reserve the authority to access necessary information from complex financial institutions – whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution – and the tools to intervene to mitigate systemic risk in advance of a crisis.

The MOU recently finalized between the SEC and the Federal Reserve is consistent with this long-term vision of the Blueprint and should help inform future decisions as our Congress considers how to modernize and improve our regulatory structure.

Market discipline is also critical to the health of our financial system, and must be reinforced, because regulation alone cannot eliminate all future bouts of market instability. For market discipline to be effective, market participants must not expect that lending from the Fed, or any other government support, is readily available. I know from first hand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

For market discipline to effectively constrain risk, financial institutions must be allowed to fail. Today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. Steps are being taken to improve market infrastructure, especially where our financial firms are highly intertwined - the OTC derivatives market and the tri-party repurchase agreement market, which is the marketplace through which our financial institutions obtain large amounts of secured funding.

It is clear that some institutions, if they fail, can have a systemic impact. Looking beyond immediate market challenges, last week I laid out my proposals for creating a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible, and – to reinforce market discipline – the trigger for invoking such authority should be very high, such as a bankruptcy filing. Any potential commitment of government support should be an extraordinary event that requires the engagement of the Treasury Department and contains sufficient criteria to prevent costs to the taxpayer to the greatest extent possible.

This work will not be done easily. It must begin now, and begin in earnest. Thank you.

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